RISK MANAGEMENT SYSTEMS PRACTICED IN CO-OPERATIVE BANKS IN INDIA

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Abstract:

2.1 *This paper explores the risk management system practiced in Co-operative Banks of India Liberalization policy and economic reforms in India explored many opportunities for the banks from mere lending and buying to other financial facilities. As a result of this banks begun to experience numerous positive changes and successive growth. By this banks made a remarkable step in the Indian banking scenario. The major concern of the co-operative bank is the mounting amount of Non-performing assets (NPAs). Hence banks should adopt a systematic risk management system to manage the overall risk exposure associated with banking operation. The present study attempted to analyse the various aspects of the risk management system practiced in Co-operative Banks in India. The secondary data has been used for this study.* The global trend is towards centralising risk management with integrated treasury management function to benefit from information on aggregate exposure, natural netting of exposures, economies of scale and easier reporting to top management. The primary responsibility of understanding the risks run by the bank and ensuring that the risks are appropriately managed should clearly be vested with the Board of Directors. The Board should set risk limits by assessing the bank's risk and risk- bearing capacity. At organisational level, overall risk management should be assigned to an independent Risk Management Committee or Executive Committee of the top Executives that reports directly to the Board of Directors. The purpose of this top level committee is to empower one group with full responsibility of evaluating overall risks faced by the bank and determining the level of risks which will be in the best interest of the bank. At the same time, the Committee should hold the line management more accountable for the risks under their control, and the performance of the bank in that area. The functions of Risk Management Committee should essentially be to identify, monitor and measure the risk profile of the bank. The Committee should also develop policies and procedures, verify the models that are used for pricing complex products, review the risk models as development takes place in the markets and also identify new risks. The risk policies should clearly spell out the quantitative prudential limits on various segments of banks' operations. Internationally, the trend is towards assigning risk limits in terms of portfolio standards or Credit at Risk (credit risk) and Earnings at Risk and Value at Risk (market risk). The Committee should design stress scenarios to measure the impact of unusual market conditions and monitor variance between the actual volatility of portfolio value and that predicted by the risk measures. The Committee should also monitor compliance of various risk parameters by operating Departments.

Keywords: *Risk management; Credit risk; Liquidity risk; Interest Rate Risk; Non-performing assets.*

1. INTRODUCTION

Banks in the process of financial intermediation are confronted with various kinds of financial and non-financial risks viz., credit, interest rate, foreign exchange rate, liquidity, equity price, commodity price, legal, regulatory, reputational, operational, etc. These risks are highly interdependent and events that affect one area of risk can have ramifications for a range of other risk categories. Thus, top management of banks should attach considerable importance to improve the ability to identify measure, monitor and control the overall level of risks undertaken.

3. OBJECTIVES OF THE STUDY

This study has the following objectives:

a. To explore the overview of Risk Management System in India
b. To explore the various kinds of risk management system adopted in Co-operative Banks in India in general and particularly in Karnataka.

3.1.1 RISK RATING

Banks should have a comprehensive risk scoring / rating system that serves as a single point indicator of diverse risk factors of a counterparty and for taking credit decisions in a consistent manner. To facilitate this, a substantial degree of standardization is required in ratings across borrowers. The risk rating system should be designed to reveal the overall risk of lending, critical input for setting pricing and non-price terms of loans as also present meaningful information for review and management of loan portfolio. The risk rating, in short, should reflect the underlying credit risk of the loan book. The rating exercise should also facilitate the credit granting authorities some comfort in its knowledge of loan quality at any moment of time.

3.1.2 RISK PRICING

Risk-return pricing is a fundamental tenet of risk management. In a risk-return setting, borrowers with weak financial position and hence placed in high credit risk category should be priced high. Thus, banks should evolve scientific systems to price the credit risk, which should have a bearing on the expected probability of default. The pricing of loans normally should be linked to risk rating or credit quality. The probability of default could be derived from the past behaviour of the loan portfolio, which is the function of loan loss provision/charge offs for the last five years or so. There is, however, a need for comparing the prices quoted by competitors for borrowers perched on the same rating /quality. Thus, any attempt at price-cutting for market share would result in mispricing of risk and 'Adverse Selection'.

3.1.3 PORTFOLIO MANAGEMENT

The existing framework of tracking the Non-Performing Loans around the balance sheet date does not signal the quality of the entire Loan Book. Banks should evolve proper systems for identification of credit

weaknesses well in advance. Most of international banks have adopted various portfolio management techniques for gauging asset quality. The CRMD, set up at Head Office should be assigned the responsibility of periodic monitoring of the portfolio. The portfolio quality could be evaluated by tracking the migration (upward or downward) of borrowers from one rating scale to another. This process would be meaningful only if the borrower-wise ratings are updated at quarterly / half-yearly intervals. Data on movements within grading categories provide a useful insight into the nature and composition of loan book.

3.1.4 LOAN REVIEW MECHANISM (LRM)

LRM is an effective tool for constantly evaluating the quality of loan book and to bring about qualitative improvements in credit administration. Banks should, therefore, put in place proper Loan Review Mechanism for large value accounts with responsibilities assigned in various areas such as, evaluating the effectiveness of loan administration, maintaining the integrity of credit grading process, assessing the loan loss provision, portfolio quality, etc. The complexity and scope of LRM normally vary based on banks' size, type of operations and management practices. It may be independent of the CRMD or even separate Department in large banks.

4. CREDIT RISK AND INVESTMENT BANKING

Significant magnitude of credit risk, in addition to market risk, is inherent in investment banking. The proposals for investments should also be subjected to the same degree of credit risk analysis, as any loan proposals. The proposals should be subjected to detail appraisal and rating framework that factors in financial and non-financial parameters of issuers, sensitivity to external developments, etc. The maximum exposure to a customer should be bank-wide and include all exposures assumed by the Credit and Treasury Departments.

5. CREDIT RISK IN OFF-BALANCE SHEET EXPOSURE

Banks should evolve adequate framework for managing their exposure in off-balance sheet products like forex forward contracts, swaps, options, etc. as a part of overall credit to individual customer relationship and subject to the same credit appraisal, limits and monitoring procedures. Banks should classify their off-balance sheet exposures into three broad categories - full risk (credit substitutes) - standby letters of credit, money guarantees, etc, medium risk (not direct credit substitutes, which do not support existing financial obligations) - bid bonds, letters of credit, indemnities and warranties and low risk - reverse repos, currency swaps, options, futures, etc.

6. INTER-BANK EXPOSURE AND COUNTRY RISK

A suitable framework should be evolved to provide a centralised overview on the aggregate exposure on other banks. Bank-wise exposure limits could be set on the basis of assessment of financial performance, operating efficiency, management quality, past experience, etc. Like corporate clients, banks should also be rated and placed in range of 1-5, 1-8, as the case may be, on the basis of their credit quality. The limits so arrived at should be allocated to various operating centres and followed up and half-yearly/annual reviews undertaken at a single point. Regarding exposure on overseas banks, banks can use the country ratings of

international rating agencies and classify the countries into low risk, moderate risk and high risk. Banks should endeavour for developing an internal matrix that reckons the counterparty and country risks. The maximum exposure should be subjected to adherence of country and bank exposure limits already in place. While the exposure should at least be monitored on a weekly basis till the banks are equipped to monitor exposures on a real time basis, all exposures to problem countries should be evaluated on a real time basis.

7. INTEREST RATE RISK (IRR)

The management of Interest Rate Risk should be one of the critical components of market risk management in banks. The regulatory restrictions in the past had greatly reduced many of the risks in the banking system. Deregulation of interest rates has, however, exposed them to the adverse impacts of interest rate risk. The Net Interest Income (NII) or Net Interest Margin (NIM) of banks is dependent on the movements of interest rates. Any mismatches in the cash flows (fixed assets or liabilities) or repricing dates (floating assets or liabilities), expose banks' NII or NIM to variations. The earning of assets and the cost of liabilities are now closely related to market interest rate volatility.

Gap or Mismatch Risk:

A gap or mismatch risk arises from holding assets and liabilities and off-balance sheet items with different principal amounts, maturity dates or repricing dates, thereby creating exposure to unexpected changes in the level of market interest rates.

Basis Risk

Market interest rates of various instruments seldom change by the same degree during a given period of time. The risk that the interest rate of different assets, liabilities and off-balance sheet items may change in different magnitude is termed as basis risk. The degree of basis risk is fairly high in respect of banks that create composite assets out of composite liabilities.

Embedded Option Risk

Significant changes in market interest rates create another source of risk to banks' profitability by encouraging prepayment of cash credit/demand loans/term loans and exercise of call/put options on bonds/debentures and/or premature withdrawal of term deposits before their stated maturities. The embedded option risk is becoming a reality in India and is experienced in volatile situations.

Yield Curve Risk

In a floating interest rate scenario, banks may price their assets and liabilities based on different benchmarks, i.e. TBs yields, fixed deposit rates, call money rates, MIBOR, etc. In case the banks use two different instruments maturing at different time horizon for pricing their assets and liabilities, any non-parallel movements in yield curves would affect the NII.

Price Risk

Price risk occurs when assets are sold before their stated maturities. In the financial market, bond prices and yields are inversely related. The price risk is closely associated with the trading book, which is created for making profit out of short-term movements in interest rates.

Reinvestment Risk

Uncertainty with regard to interest rate at which the future cash flows could be reinvested is called reinvestment risk. Any mismatches in cash flows would expose the banks to variations in NII as the market interest rates move in different directions.

Net Interest Position Risk

The size of nonpaying liabilities is one of the significant factors contributing towards profitability of banks. When banks have more earning assets than paying liabilities, interest rate risk arises when the market interest rates adjust downwards.

8. FOREIGN EXCHANGE (FOREX) RISK

The risk inherent in running open foreign exchange positions have been heightened in recent years by the pronounced volatility in forex rates, thereby adding a new dimension to the risk profile of banks' balance sheets. Forex risk is the risk that a bank may suffer losses as a result of adverse exchange rate movements during a period in which it has an open position, either spot or forward, or a combination of the two, in an individual foreign currency. The banks are also exposed to interest rate risk, which arises from the maturity mismatching of foreign currency positions. Even in cases where spot and forward positions in individual currencies are balanced, the maturity pattern of forward transactions may produce mismatches. As a result, banks may suffer losses as a result of changes in premia/discounts of the currencies concerned.

Forex Risk Management Measures

The top management should also adopt the VaR approach to measure the risk associated with exposures. Reserve Bank of India has recently introduced two statements viz. Maturity and Position (MAP) and Interest Rate Sensitivity (SIR) for measurement of forex risk exposures. Banks should use these statements for periodical monitoring of forex risk exposures.

Capital for Market Risk

The Basle Committee on Banking Supervision (BCBS) had issued comprehensive guidelines to provide an explicit capital cushion for the price risks to which banks are exposed, particularly those arising from their trading activities. The banks have been given flexibility to use in-house models based on VaR for measuring market risk as an alternative to a standardised measurement framework suggested by Basle Committee.

Operational Risk

Managing operational risk is becoming an important feature of sound risk management practices in modern financial markets in the wake of phenomenal increase in the volume of transactions, high degree of structural changes and complex support systems. The most important type of operational risk involves breakdowns in internal controls and corporate governance. Such breakdowns can lead to financial loss through error, fraud, or failure to perform in a timely manner or cause the interest of the bank to be compromised.

Measurement

There is no uniformity of approach in measurement of operational risk in the banking system. Besides, the existing methods are relatively simple and experimental, although some of the international banks have made considerable progress in developing more advanced techniques for allocating capital with regard to operational risk.

Measuring operational risk requires both estimating the probability of an operational loss event and the potential size of the loss. It relies on risk factor that provides some indication of the likelihood of an operational loss event occurring. The process of operational risk assessment needs to address the likelihood (or frequency) of a particular operational risk occurring, the magnitude (or severity) of the effect of the operational risk on business objectives and the options available to manage and initiate actions to reduce/ mitigate operational risk.

Risk Monitoring

The operational risk monitoring system focuses, *inter alia*, on operational performance measures such as volume, turnover, settlement facts, delays and errors. It could also be incumbent to monitor operational loss directly with an analysis of each occurrence and description of the nature and causes of the loss.

Control of Operational Risk

Internal controls and the internal audit are used as the primary means to mitigate operational risk. Banks could also explore setting up operational risk limits, based on the measures of operational risk. The contingent processing capabilities could also be used as a means to limit the adverse impacts of operational risk. Insurance is also an important mitigator of some forms of operational risk. Risk education for familiarising the complex operations at all levels of staff can also reduce operational risk.

Conclusion:

One of the major tools for managing operational risk is the well-established internal control system, which includes segregation of duties, clear management reporting lines and adequate operating procedures. Most of the operational risk events are associated with weak links in internal control systems or laxity in complying with the existing internal control procedures. Most of internally active banks have developed internal processes and techniques to assess and evaluate their own capital needs in the light of their risk profiles and business plans. Such banks take into account both qualitative and quantitative factors to assess economic capital. The Basle Committee now recognises that capital adequacy in relation to economic risk is a necessary condition for the long-term soundness of banks. Thus, in addition to complying with the established minimum regulatory capital requirements, banks should critically assess their internal capital adequacy and future capital needs on the basis of risks assumed by individual.

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